

Early Stage Small Business Investment Company (“SBIC”) Initiative

Overview

As part of President Obama’s [“Start-Up America Initiative”](#) SBA implemented the Early Stage SBIC Initiative to commit up to \$1 billion in SBA guaranteed leverage over a five year period to selected early stage venture funds using its current Debenture program authorization. This initiative is intended to promote American innovation and job creation by encouraging private sector investment in job-creating early stage small businesses.

Early stage small businesses face difficult challenges accessing capital, particularly those without the necessary assets or cash flow for traditional bank funding. For high-growth companies, the gap is particularly acute for seed and early stage businesses. Between 2010 and 2012, less than a third of all U.S. venture capital went to seed and early stage businesses. This gap was even more pronounced in small businesses not located in key venture areas: California, Massachusetts, and New York. Seed and early stage businesses outside these three states received less than 10% of U.S. venture capital. (ThomsonOne Moneytree)

The Early Stage SBIC Initiative will target this gap, by licensing and guaranteeing leverage to funds focused on early/seed stage investments.

Final Regulations and Call Notice

Early Stage SBIC final regulations may be found at <https://www.federalregister.gov/articles/2012/04/27/2012-10120/small-business-investment-companies-early-stage-sbics>.

The 2013 Call Notice may be found at <https://www.federalregister.gov/articles/2012/12/18/2012-30431/small-business-investment-companies-early-stage-sbics>.

Small Business Investment Company Program

[What is the SBIC Program?](#)
[SBIC Frequently Asked Questions](#)
[Early Stage Frequently Asked Questions](#)

Proposed Early Stage SBIC Quick Facts

SBA Total Commitment	Up to \$1 Billion over 5 years
Maximum leverage per SBIC	Up to \$50 million at a maximum of 1 to 1 match with private capital
Early Stage SBIC Focus	Early and seed stage
Licensing Process	Annual call between FY 2012 and FY 2016

Early Stage SBIC Key Terms

Terms	Early Stage SBIC Description Per Final Rule
Licensing	Annual Call Aggregate SBA Leverage Commitments limited to \$150 million in 2012 and \$200 million per year thereafter up to \$1 billion total SBA has right to diversify across years & geography
Regulatory Capital	\$20 million minimum (See 13 CFR 107.50 for the definition of Regulatory Capital)
Investments	50% of investment dollars into early stage. (A business is considered early stage if at the time of the SBIC's initial investment the small business being financed has not yet achieved positive cash flow from operations for any prior fiscal year.)
Maximum Leverage	Up to 1 tier of leverage, no greater than \$50 million.
Term	Ten year maturity that may be repaid in full at any time without penalty
SBA Fees	1% Commitment Fee 2% Draw Fee Annual fee set at commitment (typically under 1%) and paid quarterly with interest Licensing Fee: \$25,000 Examination Fees per § 107.692 of final rule
Leverage Description	<p>Discounted Debenture:</p> <ul style="list-style-type: none"> Interest & charges discounted for first 5 years Quarterly after first 5 years <p>or</p> <p>Standard Early Stage Debenture:</p> <ul style="list-style-type: none"> Interest & charges due and payable Quarterly Requires 5 years interest reserve (may be held as unfunded private capital commitments or in restricted cash)
Distribution Rules	Per § 107.1180 of final rule, but in general: <ul style="list-style-type: none"> Interest & charges must be paid prior to distribution Pro Rata on cumulative basis except under the following conditions: <ol style="list-style-type: none"> SBIC's Highest Leverage Ratio (Leverage/Leverageable Capital) is greater than 0.5 AND Capital Impairment Percentage ("CIP") is at or above 50% CIP or SBIC's CIP at or above maximum allowable CIP Under either of these conditions, SBA has distribution priority.
Other Key SBA Rights	Annual Examinations Above 50% CIP: SBA has specific right to require valuations on your investments. Above Maximum Allowable CIP: SBA has right to promptly transfer SBIC to Office of Liquidation

SBA Early Stage SBIC Selection Criteria

The final rule section 107.305 discusses the criteria that SBA proposes to use to select Early Stage SBICs as follows:

- ▶ Manager Qualifications
- ▶ Track Record
- ▶ Proposed Investment Strategy
- ▶ Proposed Fund Structure and Economics

SBA reserves the right to diversify across vintage years and geography as part of its licensing process. SBA also reserves the right to not license any SBIC if no applicant meets the qualifications.

Early Stage SBIC Frequently Asked Questions by Topic

This page contains frequently asked questions (“FAQs”) regarding the Early Stage Small Business Investment Company (“SBIC”) Call for Venture Funds. If you have any questions regarding the Early Stage SBIC Call Process, please submit them to startupamerica@sba.gov. SBA will try to post answers to questions here. Note: Questions with asterisks (“”) apply to both the Early Stage and regular SBIC program.*

A. FAQs Regarding Licensing

1. Question: How will the Early Stage Licensing Process work and what is the timing?
2. Question: Is there a standard Limited Partnership Agreement (“LPA”) for Early Stage SBICs?
3. Question: How do you see the geographic allocation with respect to licensing working?
4. Question: Are new funds encouraged, not just existing funds?
5. Question: If an Early Stage SBIC applicant is denied a license, can it apply in a subsequent round?
6. *Question: How will management fees be calculated?
7. *Question: Can an Early Stage SBIC applicant have pre-licensing investments?

B. FAQs Regarding Capitalizing Early Stage SBICs

1. Question: When does an applicant need to have raised its private capital?
2. Question: What evidence of committed regulatory capital will be required to be filed by Track 1 Applicants with the MAQ on March 1, 2013?
3. *Question: Can a portion of the private capital come from government (other federal, state, or local)?
5. Question: How is existing capital under management treated with respect to Regulatory Capital and leverage eligibility? Specifically, take an example of a fund that has 50% of its capital invested in portfolio companies, 20% of its capital uninvested but reserved for follow on investments in its portfolio companies, and 30% of its capital uninvested and not reserved for existing portfolio companies. How much of this capital would be considered Regulatory Capital that could be leveraged by the Early Stage SBIC program?
6. Question: Does the SBA allow two parent funds of different vintage years, but managed by the same General Partner, to drop down \$25 million of capital into each of two separate SBICs, and obtain 1:1 leverage for both funds—i.e., \$25 million of SBA leverage per fund? The SBICs will not invest in the same companies.
7. *Question: Can a drop down Early Stage SBIC invest in the parent fund’s existing portfolio companies along with the existing investor syndicate? If so, what are the limitations? Would it need to get additional participation from new third party investors?

C. FAQs Regarding Early Stage Leverage

1. Question: How will Early Stage Debenture leverage work?
2. Question: What type of interest can Early Stage SBICs expect for Early Stage Debentures?

3. Question: Can you please provide an example of how the payment stream works on a discounted early stage debenture? For example, if an Early Stage SBIC wants to make a \$5 million investment into an early stage company how much private capital would need to be invested and how much would the debenture draw be?
4. *Question: Fees are 1% commitment and 2% draw down. Are these annual fees or one-time fees?
5. Question: Can an Early Stage SBIC draw down both standard and discount debentures?
6. Question: The program offers a 1:1 match. Could an Early Stage SBIC request only \$0.50 for every dollar that it raises? So that, for example, if an Early Stage SBIC raised \$40M in Regulatory Capital, could it receive \$20M in leverage from the Early Stage SBIC program?
7. Question: If an Early Stage SBIC elects to use Early Stage discount debentures, can it use private capital to pay interest due on its debentures after 5 years?
8. Question: Since there is limited leverage associated with the Early Stage SBICs, how will the leverage be allocated in any given year?

D. FAQs Regarding Operating as Early Stage SBIC

1. Question: What are the regulatory requirements that must be met, besides the requirement that businesses be “early stage” (not have positive cash flow from operations in any prior year)?
2. *Question: What are the reporting requirements for an Early Stage SBIC?
3. Question: At what point must an Early Stage SBIC need to have met the requirement that 50% of its investment dollars be invested in early stage small businesses? Can an Early Stage SBIC fund make later stage investments?
4. Question: Are the SBA valuation guidelines for investments likely to be the same as in the current participating securities program and how will that effect the number of SBICs that may encounter Capital Impairment Percentages (CIPs) >50%?
5. *Question: Can an SBIC with less than 1:1 leverage invest more than 10% of its total capital in any one company—i.e., exceed the overline limit?
6. *Question: I am looking for information regarding the eligibility of a company for SBIC loans. If a company is owned by a holding company, and that holding company is owned by a private equity fund, does this indirect ownership by a private equity fund, which would seem to qualify as an Affiliate, disqualify the company from being eligible for an SBIC loan?

E. General FAQs

1. Question: Why would a fund manager pick the Early Stage SBIC program over the standard SBIC program?

A. FAQs Regarding Licensing

1. Question: How will the Early Stage Licensing Process work and what is the timing?

- ▶ **Answer:** SBA uses an annual call process to license Early Stage SBICs. In general the process includes the following phases: A) Call Period; B) Initial Review; C) SBIC Fundraises and Finalizes Documents; and D) Licensing.

SBA issued its first call for Early Stage SBIC applicants in FY 2012 and its second call in FY 2013. The timeline for the FY 2013 call is described below. Details regarding the FY 2013 call may be found at <https://www.federalregister.gov/articles/2012/12/18/2012-30431/small-business-investment-companies-early-stage-sbics>.

FY 2013 Call Timeline: In order to expedite applicants that have already raised sufficient capital, SBA has established two “tracks” for the Early Stage SBIC Licensing Process as follows:

- ▶ **Track 1 – Applicants with Capital:** This includes all applicants that have signed commitments for at least \$15 million in Regulatory Capital and the remaining capital needed to achieve the minimum \$20 million in Regulatory Capital for Early Stage SBICs “soft-circled”. See [call notice](#) for further details.
- ▶ **Track 2 – All Other Applicants.**

The following table provides the key milestones for each track.

Milestone	Track 1 – Applicants with Capital	Track 2 – All Other Applicants
Initial Review Period		
• Management Assessment Questionnaires (“MAQs”) Due	5 p.m. ET March 1, 2013	5 p.m. ET March 30, 2013
• Interview Period	March 25, 2013— March 29, 2013	June 3, 2013— June 14, 2013
• Anticipated Green Light Decision	April 30, 2013	September 27, 2013
Licensing Period		
• Licensing Applications Due with at least \$20 million in Regulatory Capital and desiring to be licensed by September 30, 2013.	5 p.m. ET June 7, 2013	
• All other Applicants with Green Light Letters		No later than one year from issuance of Green Light Letter
Notes: <ul style="list-style-type: none"> • SBA reserves the right to change these timelines as needed. SBA will update this website should these dates change. Applicants will be notified by email. • SBA expects to issue additional calls for Early Stage Fund Managers on an annual basis. SBA will announce these calls via a call notice in the Federal Register. 		

2. Question: Is there a standard Limited Partnership Agreement (“LPA”) for Early Stage SBICs?

- ▶ **Answer:** Yes. All Early Stage SBICs must use the Early Stage Model LPA (“Model LPA”) as a template, which you may download by clicking [here](#). Section IV of the Call Notice provides special instructions regarding the Model LPA.

Related Question: Does that mean only new funds can participate in the program? I am working with a client who currently is raising a fund and already has a LPA in place with investors. Is it possible for this client to apply and participate without having to amend and restate its LPA to match the Model LPA? For instance, is it possible set up a parallel fund structure, perhaps waive the Model LPA requirement, or use a side letter to the existing fund LPA to address Model LPA terms?

- ▶ **Answer:** The requirement to use the Model LPA is absolute. Applicants may consider forming a drop-down subsidiary, but the drop down would have to use the Model LPA, and could not contain any references to governance by the parent fund’s LPA. The SBIC’s LPA must be a self-contained document.

3. Question: How do you see the geographic allocation with respect to licensing working?

- ▶ **Answer:** SBA has not developed a specific algorithm on how it expects to allocate based on a geographic basis. All Early Stage SBICs must first meet SBA’s basic licensing criteria. After those criteria are met, SBA reserves the right to maintain diversification among Early Stage SBICs with respect to geography.

4. Question: Are new funds encouraged, not just existing funds?

- ▶ **Answer:** New funds are encouraged to apply, but the team must demonstrate some cohesion and there must be at least two Principals with a sufficient number of successful, analogous investments that they took from investment to realization.

5. Question: If an Early Stage SBIC applicant is denied a license, can it apply in a subsequent round?

- ▶ **Answer:** Applicants may reapply. However, SBA would expect that a meaningful change has occurred (such as an addition to the management team or improvement in track record through additional realizations).

6. *Question: How will management fees be calculated?

- ▶ **Answer:** Please see [13 CFR 107.520](#) and [SBIC Tech Note #7A](#). Please note that these reflect maximum management fees only. Early Stage SBICs should recognize that management expenses contribute to overall fund losses and capital impairment.

7. *Question: Can an Early Stage SBIC applicant have pre-licensing investments?

- ▶ **Answer:** Yes. However, SBA will generally not accept pre-licensing investments made prior to the applicant submitting its final licensing application.

B. FAQs Regarding Capitalizing Early Stage SBICs

1. Question: When does an applicant need to have raised its private capital?

- ▶ **Answer:** [Track 1 applicants](#) must have signed commitments of at least \$15 million in Regulatory Capital when they submit their MAQs and at least \$20 million in Regulatory Capital when they submit their Licensing Applications. Track 2 applicants must have at least \$20 million in Regulatory Capital when they submit their Licensing Applications. The answer to [question A.1 provides specific dates](#).

2. Question: What evidence of committed regulatory capital will be required to be filed by Track 1 Applicants with the MAQ on March 1, 2013?

- ▶ **Answer:** SBA will require an executed Capital Certificate backed by Letters of Intent or Subscription Agreements. "Pro Forma" submissions are not allowed.

3. *Question: Can a portion of the private capital come from government (other federal, state, or local)?

- ▶ **Answer:** The sources of private capital for SBICs, including Early stage SBICs, are described in [13 CFR 107.230](#).

4. *Question: Can a small amount of the cost basis of existing portfolio companies in a fund be contributed to the new SBIC (contribution in kind)? If not, can the shareholdings be contributed to the SBIC as portfolio companies even if their cost basis cannot be used to calculate Regulatory Capital (the reason for this would be so that reserves for these investments could be made from regulatory capital and the proceeds from these investments upon exit would be used to repay SBA leverage and generate returns for private capital investors)?

- ▶ **Answer:** SBA does not allow in-kind contributions, because they create problematic valuation issues. Consequently, even non-Regulatory Capital in-kind contributions are also not allowed. SBICs are to be de-novo investment vehicles without prior encumbrances.

5. Question: How is existing capital under management treated with respect to Regulatory Capital and leverage eligibility? Specifically, take an example of a fund that has 50% of its capital invested in portfolio companies, 20% of its capital uninvested but reserved for follow on investments in its portfolio companies, and 30% of its capital uninvested and not reserved for existing portfolio companies. How much of this capital would be considered Regulatory Capital that could be leveraged by the Early Stage SBIC program?

- ▶ **Answer:** Section 107.1150 of the [Early Stage Final rule](#) indicates both the amount of commitments an Early Stage SBIC may receive with respect to Regulatory Capital and how much leverage an Early Stage SBIC may receive with respect to Leverageable Capital. Regulatory Capital is generally defined as the contributed capital of a Licensee, plus unfunded binding commitments by Institutional Investors to contribute capital to a Licensee. Please review [13 CFR 107.50](#) and [13 CFR 107.230](#) for the exact definitions. Leverageable Capital is also defined by [13 CFR 107.50](#), but in general means Regulatory Capital minus the unfunded binding commitments. In general, Early Stage SBICs may receive leverage commitments equal to Regulatory Capital up to \$50 million, but may only have leverage outstanding at any time equal to their Leverageable Capital.
- ▶ As an example: An Early Stage SBIC has \$35 million in unfunded binding commitments by Institutional Investors plus \$5 million in contributed capital. Regulatory capital will equal \$40 million and Leverageable Capital will equal \$5 million. The Early Stage SBIC may receive up to \$40 million in Early Stage Debenture commitments and may issue up to \$5 million in SBA guaranteed leverage. As the SBIC draws more private capital, it may issue more SBA leverage from its remaining commitments. The SBIC may draw from its SBA leverage commitments for 4 years after the government fiscal year end (September 30) in which it received its commitments. So, if the SBIC received its \$40 million leverage commitment on September 30, 2012, it will be able to draw from that commitment through September 30, 2016.

6. Question: Does the SBA allow two parent funds of different vintage years, but managed by the same General Partner, to drop down \$25 million of capital into each of two separate SBICs, and obtain 1:1 leverage for both funds—i.e., \$25 million of SBA leverage per fund? The SBICs will not invest in the same companies.

- ▶ **Answer:** No, this is specifically prohibited under the Early Stage Regulations; you may not have two or more licensees simultaneously in operation that are under

Common Control (managed by same GP). Additionally, Applicants may not structure a “double drop-down” with each fund investing into a single SBIC either. This would result in an overly complex legal structure not contemplated by the current time-frames.

7. *Question: Can a drop down Early Stage SBIC invest in the parent fund’s existing portfolio companies along with the existing investor syndicate? If so, what are the limitations? Would it need to get additional participation from new third party investors?

- ▶ **Answer:** The action would be subject to the requirements of the conflict of interest regulations found under section 13 CFR 107.730. It may or may not be necessary to include a third-party; each case is different and the specific circumstances have to be considered. In general, SBA looks for terms and conditions that are fair and equitable to the SBIC.

C. FAQs Regarding Early Stage Leverage

1. Question: How will Early Stage Debenture leverage work?

- ▶ **Answer:** Similar to the regular SBIC Debenture program, Early Stage SBICs first receive a leverage commitment. The Early Stage SBIC must pay a 1% commitment fee at the time of commitment. (No other leverage charges are incurred until the Early Stage SBIC issues leverage.) SBA Debenture commitments are good through the end of the fourth fiscal year after the commitment was approved. For example, if you received an SBA commitment on September 25, 2012, the commitment would end on September 30, 2016. During that timeframe, the SBIC may issue Debentures at any time, barring regulatory issues.
- ▶ Early Stage SBICs must pay a 2% draw fee at the time of draw. Unlike the standard SBIC Debenture, Early Stage Debentures will not be pooled. The Federal Home Loan Bank of Chicago (“FHLBC”) has agreed to purchase all Early Stage Debentures and hold them until maturity. Interest rates for this debenture will be determined by FHLBC on the draw date as a spread over the FHLBC’s cost of funds.
- ▶ Early Stage SBICs will be eligible to utilize two types of Early Stage Debentures:
 1. Standard: Interest and annual charges will be due on a quarterly basis. Early Stage SBICs are required to maintain a 5 year interest and annual charge reserve (which may be held as unfunded private capital commitments or in restricted cash).

2. Discounted: Leverage will be issued at a discount based on 5 years of interest and annual charges. After the fifth year, SBICs will be required to pay such interest and charges on a quarterly basis.

2. Question: What type of interest can Early Stage SBICs expect for Early Stage Debentures?

- ▶ **Answer:** Unlike standard debentures, Early Stage Debentures will not be pooled. They will be purchased and held through maturity or prepayment by the Federal Home Loan Bank of Chicago ("FHLBC").
- ▶ In general, FHLBC will set a rate above its own cost based on the terms of the debenture at the time of issuance.
- ▶ FHLBC's Debenture calculator provides current rates for Early Stage Debentures. It is located at <http://www.fhlbc.com/Documents/sbacalculatorpage.htm>.

3. Question: Can you please provide an example of how the payment stream works on a discounted early stage debenture? For example, if an Early Stage SBIC wants to make a \$5 million investment into an early stage company how much private capital would need to be invested and how much would the debenture draw be?

- ▶ **Answer:** The Early Stage Discount Debenture is very similar to the 10 year LMI Debenture in that the debenture is issued at a discount so that the issuer does not have to pay interest or annual charges for the first five years. After five years, Early Stage SBICs will need to make quarterly payments for interest and annual charges.
- ▶ Also, similar to the LMI Debenture, Early Stage Debentures will not be pooled, but will be held by the FHLBC through maturity or prepayment.
- ▶ FHLBC's calculator estimates the amount of gross proceeds that Early Stage SBICs can expect: <http://www.fhlbc.com/Documents/sbacalculatorpage.htm>. (This calculator should be updated by mid-January 2013 to include Early Stage.)

4. *Question: Fees are 1% commitment and 2% draw down. Are these annual fees or one-time fees?

- ▶ **Answer:** The 1% commitment fee is a one-time fee. The 2% draw down fee is charged each time you draw leverage, but is limited to 2% of the amount drawn. SBA also charges an annual fee based on outstanding leverage. The annual fee is set at the time of commitment, but may be no higher than the statutory limit of 1.38%.

SBA's annual fee has never exceeded 1%. For leverage drawn from commitments approved in FY 2013 the annual fee is 76 basis points.

5. Question: Can an Early Stage SBIC draw down both standard and discount debentures?

- ▶ **Answer:** An Early Stage SBIC may draw down both **Early Stage** standard and discount debentures. However, Early Stage SBICs will not have access to the regular program's Debenture leverage. Similarly, SBIC's licensed through the standard debenture program will not have access to Early Stage Debenture leverage.

6. Question: The program offers a 1:1 match. Could an Early Stage SBIC request only \$0.50 for every dollar that it raises? So that, for example, if an Early Stage SBIC raised \$40M in Regulatory Capital, could it receive \$20M in leverage from the Early Stage SBIC program?

- ▶ **Answer:** Yes. Applicants may take less than 1:1 leverage, but they should clearly indicate how much leverage they are requesting.

7. Question: If an Early Stage SBIC elects to use Early Stage discount debentures, can it use private capital to pay interest due on its debentures after 5 years?

- ▶ **Answer:** Yes. Early Stage SBICs may use investment proceeds or private capital draws to pay interest on its debentures.

8. Question: Since there is limited leverage associated with the Early Stage SBICs, how will the leverage be allocated in any given year?

- ▶ **Answer:** SBA Early Stage commitments depend on the amount of leverage available in any given fiscal year. If leverage is available, Early Stage SBICs may receive their full commitment (1 tier up to \$50 million) at licensing. SBA will allocate Early Stage leverage on a first licensed basis up to the amount approved at licensing.
- ▶ By creating periodic application windows, SBA will be able to gauge the overall demand for leverage and allocate the available funds among all successful applicants. Up to a maximum of \$50 million per fund, SBA intends to make one full tier of leverage available to each licensed Early Stage SBIC (unless the SBIC requests less) and will stop licensing new funds. Depending on demand, SBA may need to commit leverage to Early Stage SBICs in tranches spread over several years, rather than providing a full one-tier commitment at the time of licensing.
- ▶ **Example:** Early Stage SBIC is licensed with \$25 million in Private Capital. It only receives a \$15 million leverage commitment when licensed due to allocation issues. The SBIC may apply in another year for an additional \$10 million leverage commitment.

D. FAQs Regarding Operating as Early Stage SBIC

1. Question: What are the regulatory requirements that must be met, besides the requirement that businesses be “early stage” (not have positive cash flow from operations in any prior year)?

- ▶ **Answer:** All businesses must qualify as a U.S. “small business” to receive SBIC financing.
- ▶ Small businesses are generally defined as businesses with a tangible net worth < \$18 million **AND** average after-tax income for prior two years of < \$6 million
- ▶ **OR** Businesses that qualify as “small” under SBA’s N.A.I.C.S. Industry Code standards (generally under 500 employees)
- ▶ [13 CFR Part 107, Subpart G](#) further defines the rules regarding eligible SBIC financings. A few of these are listed in the chart below.

Other Major SBIC Investment Requirements		
Area	SBICs May Invest	SBICs May NOT Invest
Investments	<ul style="list-style-type: none">• Loans• Debt with Equity features• Equity	<ul style="list-style-type: none">• More than 10% of the proposed total fund size in a single company without SBA approval
Use of Proceeds	<ul style="list-style-type: none">• Small businesses in non-prohibited areas	<ul style="list-style-type: none">• Project Finance• Real Estate• Financial Intermediaries
Geography	<ul style="list-style-type: none">• In businesses located anywhere in the U.S. or its territories	<ul style="list-style-type: none">• In businesses with over 49% of their employees located outside the U.S.

2. *Question: What are the reporting requirements for an Early Stage SBIC?

- ▶ **Answer:** The reporting requirements are the same as in the regular SBIC program. SBIC reporting requirements are governed by 13 CFR Part 107, Subpart F. Key reporting includes annual financial statements (Form 468) and for leveraged SBICs (SBICs with either outstanding leverage or leverage commitments) quarterly financial statements (short Form 468). SBICs must also provide a Portfolio Financing Report (Form 1031) within 30 days after the close of each financing.

3. Question: At what point must an Early Stage SBIC need to have met the requirement that 50% of its investment dollars be invested in early stage small businesses? Can an Early Stage SBIC fund make later stage investments?

- ▶ **Answer:** When an Early Stage SBIC fund's investments (in dollars) are at least equal to its Private Regulatory Capital, SBA will review the portfolio to see whether the Early Stage SBIC meets the test of 50%. This does not prohibit an Early Stage SBIC from making later stage investments. As a reminder, all follow-ons into a portfolio company defined as "early stage" (not operating cash flow positive in any prior fiscal year) at the initial financing will be considered an early stage investment.

4. Question: Are the SBA valuation guidelines for investments likely to be the same as in the current participating securities program and how will that effect the number of SBICs that may encounter Capital Impairment Percentages (CIPs) >50%?

- ▶ **Answer:** The valuation guidelines will be the same. However, SBA made two key changes in its final rule:
- ▶ **Change 1 – Allowances for Leverage Ratios Below .5:** If an Early Stage SBIC takes down less than or equal to half a tier of leverage (leverage less than or equal to .5 x leverageable capital), SBA will not take priority in distributions until the SBIC is over its maximum allowable CIP. It should be noted that with only half a tier of leverage, the SBIC would need to have extensive losses before it reaches its maximum allowable CIP (typically 70%). This change encourages Early Stage SBICs to manage their risk by taking down less leverage.
- ▶ **Change 2 – Extension of Class 2 Appreciation Expiration:** The CIP definition only allows certain classes of appreciation to offset realized losses. In particular, Class 2 appreciation arises when an SBIC holds an investment in a company that subsequently receives a new round of financing at a higher price, provided the new round includes a substantial investment by a sophisticated, new, non-strategic investor in an arm's length transaction. SBA regulations allow Class 2 appreciation (discounted by 50 percent) to offset realized losses in the CIP computation, but in most cases only for 24 months after the new round of financing takes place. Historically, this has been the primary reason that an otherwise financially sound SBIC has been impaired.

Therefore, SBA's final regulations provide that at the end of the initial 24 months, an Early Stage SBIC with "expiring" Class 2 appreciation will be able to request an extension based on an independent third-party valuation of the investment or other information acceptable to SBA. In certain instances, based on the valuation of the investment, SBA will permit the Early Stage SBIC to use the Class 2 appreciation in its

CIP computation without the 50 percent discount. Full details of these changes are discussed in the [Early Stage Final rule](#) under § 107.1845.

5. *Question: Can an SBIC with less than 1:1 leverage invest more than 10% of its total capital in any one company—i.e., exceed the overline limit?

- ▶ **Answer:** The overline limit was updated due to legislative changes. While SBA believes requests to exceed the overline limit should be rare, it remains possible to request an exemption. The exemption must be approved by the Associate Administrator for the Office of Investment and Innovation. In general, Early Stage SBICs should not plan to exceed this overline limit as SBA believes that portfolio diversity is important in risk management.

6. *Question: I am looking for information regarding the eligibility of a company for SBIC loans. If a company is owned by a holding company, and that holding company is owned by a private equity fund, does this indirect ownership by a private equity fund, which would seem to qualify as an Affiliate, disqualify the company from being eligible for an SBIC loan?

- ▶ **Answer:** This appears to be a permissible leveraged buyout transaction where SBICs provide mezzanine capital to companies with a private equity sponsor.

E. General FAQs

1. Question: Why would a fund manager pick the Early Stage SBIC program over the standard SBIC program?

- ▶ **Answer:** As part of its licensing process, SBA looks closely at the fund's strategy and its compatibility to the Debenture leverage. As a result, SBA typically doesn't license applicants to issue leverage if they intend to perform a large percentage of early stage investments. This is because the Debenture leverage requires semi-annual interest payments, which is typically incompatible with early stage investing. In addition, the risk profile associated with Early Stage tends to make it inappropriate to the standard SBIC Debenture program. SBA's final [rule](#) provides for several measures to make the Early Stage SBIC program more compatible with early stage investing.
- ▶ Applicants that are not interested in leverage may find several benefits to the SBIC program as a non-leveraged SBIC, including the following:
 - ▶ Only annual financial reporting (Form 468) is required versus quarterly for leveraged SBICs.

- ▶ Fewer examinations; typically once every 2 years versus every year for leveraged SBICs.
- ▶ Lower private capital requirements; \$5 million in private capital versus the proposed \$20 million for Early Stage SBICs.
- ▶ No distribution restrictions.
- ▶ Non-leveraged SBICs have the same regulatory benefits as any SBIC, including:
 - ▶ **SEC Registration Exemption Benefits:** *SBICs are exempt from SEC registration requirements. Yet, LPs benefit from the careful monitoring done by the SBA, greatly reducing the risk for fraud and abuse.*
 - ▶ **Volcker Rule Exemption Benefits:** *Bank investments into SBICs are exempt from the 3% cap set forth by the Volcker Rule enacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL-111-203)*
 - ▶ **Community Reinvestment Act:** *Investments in Small Business Investment Companies are presumed qualified for Community Reinvestment Act credits.*